BEFORE

THE PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA

DIRECT TESTIMONY

OF

AARON L. ROTHSCHILD

ACCOUNTING

ON BEHALF OF

THE SOUTH CAROLINA DEPARTMENT OF CONSUMER AFFAIRS

Docket No. 2019-281-S

May 26, 2020

Contents

I. STATEMENT OF QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.

A. My name is Aaron L. Rothschild. My title is President and my business address is 15 Lake Road, Ridgefield, CT.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am President of Rothschild Financial Consulting.

Q. PLEASE STATE YOUR EDUCATIONAL ACHIEVEMENTS AND PROFESSIONAL DESIGNATIONS?

A. I have a B.A. (1994) degree from Clark University in mathematics and an M.B.A. (1996) from Vanderbilt University.

Q. PLEASE DESCRIBE YOUR BUSINESS EXPERIENCE.

A. I provided financial analysis in the telecom industry in the United States and Asia Pacific from 1996 to 2001, investment banking consulting in New York, complex systems science research regarding the power sector at an independent research institute, and I have prepared rate of return testimonies since 2002. My business experience includes providing expert witness services to the California Public Advocates Office to evaluate the financial health, basic operation, wildfire cost recovery, and organizational culture/governance of gas and electric utilities (I.15-08-019), including evaluating bankruptcy restructuring plans for Pacific Gas and Electric. See Exhibit ALR-1 for my resume.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THIS COMMISSION, OR OTHER STATE COMMISSIONS? IF SO, WHICH COMMISSIONS?

A. Yes, I have testified before this Commission previously. My expert witness experience includes testifying in over 50 cost of capital proceedings before the following state

commissions: California, Colorado, Connecticut, Delaware, Florida, New Jersey, Maryland, North Dakota, Pennsylvania, South Carolina and Vermont. See Exhibit ALR-1 for the list of dockets for each of my testimonies.

Q. ON WHOSE BEHALF ARE YOU PROVIDING THIS TESTIMONY?

A. South Carolina Department of Consumer Affairs.

Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to provide my recommendations to the Public Service Commission of South Carolina ("Commission") regarding the following two issues that will impact rates for Palmetto Utilities Inc. ("PUI" or "Company"): (1) the appropriate adjustments to reflect the effect of the Federal Tax Cuts and Jobs Act ("TCJA"), and (2) the appropriate regulatory treatment of the $18 million acquisition of sewer collection system from the City of Columbia ("City").

II. SUMMARY OF CONCLUSIONS

Q. PLEASE SUMMARIZE YOUR TESTIMONY

A. I recommend the following regarding the TCJA and the treatment of Contributions in Aid of Construction ("CIAC"):

1. **TCJA:** Commission order PUI to refund ratepayers the accumulated excess deferred income taxes they collected as a result of the passage of the TCJA. As explained later in my testimony, I recommend the Commission follow IRS requirements regarding normalization and flow-through.

2. **City Sewer Collection System Acquisition:** $1.29 million of the $18 million acquisition price be allowed to go into rate base.

III. TAX CUTS AND JOBS ACT

Q. WHY ARE DEFERRED TAXES AN ISSUE IN THIS CASE?

A. Starting on January 1, 2018, the maximum corporate income tax rate was lowered from 35 percent to 21 percent. The provision for deferred income taxes charged to ratepayers in PUI's last rate case was based on a provision for deferred income taxes using the 35 percent rates of the old law. Therefore, ratepayers continued to pay for a provision for deferred taxes at the 35 percent rate. Because of this, within the spirit of the use of normalization accounting, ratepayers are entitled to the benefits of the deferred taxes they were paying. These excess taxes ratepayers paid since the January 1, 2018 tax law change would truly be "phantom" tax payments if ratepayers were to permanently lose the benefit of these taxes in excess of the statutory rate that the company actually paid.

Q. DOES THE COMPANY DISPUTE THAT THE CORPORATE INCOME TAX RATE WAS LOWERED TO 21 PERCENT SINCE ITS RATES WERE ESTABLISHED?

A. No. However, company witness Mr. Walsh states on page 6 of his direct testimony that he believes returning the payments made by ratepayers at the higher tax rate, even after the rate had been changed, would constitute retroactive ratemaking. He also believes that adjusting for the change in the income tax expense constitutes retroactive ratemaking. He proposes the company simply keep the excess payments and return none of them to ratepayers.

Q. SHOULD THE COMPANY BE ALLOWED TO KEEP THOSE EXCESS PAYMENTS?

A. No. As stated below, refunding consumers excess deferred income taxes ("EDIT") is not retroactive ratemaking because the utility company does not own these funds. Looking at the long history of this issue shows that the very existence of the provision for deferred taxes was a compromise between what companies wanted and the flow through accounting that ratepayers preferred. Denying consumers the portion of the tradeoff that helps them would be unfair and unreasonable.

Q. WHAT ARE DEFERRED INCOME TAXES?

A. Deferred income taxes are the difference between the current income tax expense that a company records on its income statement, and the income taxes it actually has to pay on the income earned in that period. When the income tax expense recorded on the income statement is larger than the income tax payment a company is currently liable to pay, the company gets the use of the difference between the per books income tax expense and the current actual expense.

Typically, deferred income taxes occur because the tax law permits a company to depreciate its assets for tax purposes more rapidly than what the company's accounting system records for depreciation expense. The accounting depreciation expense is intended to charge to expenses the original cost of an asset over the best estimate of its useful life. The tax basis depreciation expense is based on whatever the taxing authority permits. Typically, the depreciation rate allowed for tax purposes is higher than the per books depreciation expense rate because of some combination of the use of a depreciation life shorter than its expected actual life, or because of accelerated depreciation methods

permitted for tax purposes that compute depreciation expense higher in the early part of an asset's life than if a straight-line method of depreciation were used. This results in ratepayers paying more in taxes than the utility is actually paying the IRS in the early years of the asset's useful life and less after the asset is fully depreciated.

Q. IS THE PER TAXES DEPRECIATION EXPENSE ALWAYS HIGHER THAN THE PER BOOKS DEPRECIATION EXPENSE?

A. No. While income tax computations often permit a depreciation expense that is higher than the depreciation expense a company records on its books for operating expense purposes during the earlier part of the life of an asset, the per tax depreciation expense eventually becomes lower than the per books depreciation expense. For any one specific asset, once the asset becomes old enough, the tax depreciation rate becomes less than the per books depreciation rate. When that happens, at least with respect to that one specific asset, the income taxes paid currently will become higher than the per books income tax expense.

Q. HOW IS THE DIFFERENCE BETWEEN THE PER BOOKS INCOME TAX EXPENSE AND THE ACTUAL YEAR'S TAX PAYMENT REFLECTED FOR PER BOOK PURPOSES?

A. The difference between the per books income tax expense and the actual "per tax" income tax expense is recorded on the income statement as a provision for deferred income taxes. This provision for deferred income taxes is not really a current expense. It is an income tax expense the company will have to pay sometime in the future. To properly communicate to investors that the company has this ongoing liability to make these higher

income tax expenses in the future, the income statement provisions for income taxes are accumulated on a company's balance sheet as an accumulated provision for income taxes.

Q. WHAT IS THE RATEMAKING TREATMENT FOR DEFERRED INCOME TAXES?

A. Several decades ago, there was disagreement on how to treat income tax expense for ratemaking purposes. Some jurisdictions would "flow through" the tax benefit of the lower actual income tax expense directly to ratepayers within the rate case. This method, called "flow through" immediately gave the tax timing benefit to ratepayers. Other jurisdictions used "normalization" instead of "flow through," where the per books income tax amount was charged to ratepayers and any accumulated provision for deferred taxes was subtracted from rate base. Then, in 1986, there was a change in the income tax law that required utility ratemaking to use the normalization method, or lose the benefit of lower taxes. Utility commissions responded by abandoning "flow through" in exchange for the currently used "normalization" method. People who argued in favor of "flow through" accounting for the tax timing benefit typically referred to the provision for deferred income taxes as "phantom taxes." Once the tax law was changed, however, all realized that it was better for ratepayers to allow the company to have the tax savings so long as the provision for deferred taxes was accumulated on the balance sheet of the company. Since the provision for deferred taxes is a standard rate base deduction, ratepayers still benefited from the tax savings, albeit more slowly than if "flow through" accounting had been used.

Q. PLEASE SUMMARIZE MR. WALSH'S RECOMMENDATION THAT CONSUMERS SHOULD NOT BE GIVEN A REFUND FOR THE PORTION OF

RATES COLLECTED WHICH INCLUDED INCOME TAXES AT THE HIGHER TAX RATES PREVAILING PRIOR TO THE EFFECTIVE DATE OF THE TCJA.

A. Mr. Walsh claims that ratepayers should not be given a refund as result of the TCJA for two reasons. First, Mr. Walsh claims that refunding consumers "constitutes impermissible retroactive ratemaking."[1] Second, he claims that such a refund would constitute single issue ratemaking. In particular, Mr. Walsh claims that "it is improper to consider the lawfulness of a public utility's rates at a given point in time by reference to a single expense and without consideration of whether the public utility is earning in excess of an authorized return or margin."[2]

Q. PLEASE RESPOND TO MR. WALSH'S RECOMMENDATION.

A. Mr. Walsh is correct that after-the-fact rate adjustments, referred to as "retroactive ratemaking" should not be permitted. He is not correct, however, that refunding consumers for paying PUI more than the company will have to pay the IRS is retroactive ratemaking.

Cost of service regulation is prospective in nature. In other words, a utility company's revenue requirement is authorized based on projections during a rate case proceeding. A utility's actual revenues between rate cases will never match its authorized revenue requirement exactly. A utility is given the opportunity to earn its allowed rate of return, but it is not given a guarantee. If a utility is able to increase its earnings and rate of return, through efficient management or good luck, it is entitled to the higher returns. On the other hand, if costs turn out to be higher than expected, because of poor management or bad luck, the utility company may earn less than its authorized return.[3] Regulators

[1] Mr. Walsh's Direct Testimony, page 6, lines 22-23.
[2] Ibid. lines 28-31.
[3] Cost recovery for storm damage is an exception.

typically do not adjust rates up or down based on retroactive conditions to make actual returns equal to their authorized rate of return. Regulators typically do not refund consumers for earnings above their authorized rate of return because it would violate investors expectation that utility rates will remain the same until they are changed prospectively in their next rate case.

However, retroactive ratemaking, should not apply to the cumulative amount of taxes that has been collected from ratepayers but has not yet been paid to the IRS because the intent was that these funds would be returned to ratepayers. These funds were put into a liability account on the balance sheet because they are for the benefit of ratepayers, not investors. These funds collected from ratepayers are called accumulated deferred income taxes (ADIT)[4]. PUI cannot use ADIT to pay investors dividends because they are not earnings. These funds do not impact PUI's rate of return directly and PUI certainly does not own these funds. Refunding money that was set aside for consumes does not constitute retroactive ratemaking.

Q. PLEASE COMMENT ON DECISIONS MADE BY OTHER UTILITY COMMISISONS REGARDING REFUNDING EXCESS INCOME TAXES COLLECTED.

A. My recommendation to return the additional ADIT to consumers as a result of the TCJA is consistent with the all the decisions I have seen in states around the country. For example, on December 4, 2019, the Public Utilities Commission of Ohio agreed to allow Dominion Energy Ohio to create a credit on gas customer bills to reflect the impact that the Tax Cuts and Jobs Act (TCJA) of 2017 had on its tax rates (Case 18-1908-GA-UNC).

[4] ADIT is removed from rate base. Deferred taxes are added to rate base as they are paid to the IRS in future years.

The company will return to customers normalized excess deferred income tax (EDIT) estimated to be approximately $181 million over about 6 years.[5]

Q. HOW DO YOU PROPOSE RATEPAYERS BE PAID BACK THESE EXCESS TAXES THAT WERE BUILT INTO THE RATES THEY PAID?

It is undeniable that consumers should receive the benefit of EDIT. I am recommending the following:

1. Protected EDIT[6] should be included in ADIT
2. Unprotected EDIT should be included in ADIT or flowed-through in current rates.

It could be reasonable for the Commission to use the portion of the EDIT which is available for flow-through (Unprotected EDIT) to reduce current rates instead of remaining part of ADIT. Current ratepayers are often burdened with paying for plant being included in rate base that will primarily benefit future ratepayers.

IV. ACQUISITION OF THE CITY'S SEWER COLLECTION SYSTEM

Q. PLEASE EXPLAIN THE PURPOSE OF YOUR TESTIMONY REGARDING THE REGULATORY TREATMENT OF THE $18 MILLION ACQUISITION OF THE CITY OF COLUMBIA'S SEWER COLLECTION SYSTEM.

A. The purpose of this section of my testimony is to recommend how much of the $18 million acquisition price paid by Palmetto Richland County ("PRC") in 2013 should be allowed in PUI's rate base. The criteria I use for determining this amount starts and ends with just and

[5] https://www.puco.ohio.gov/media-room/media-releases/puco-approves-dominion-tax-cut-rate-reductions/

[6] For benefits given to ratepayers, Protected EDIT must be normalized while Unprotected EDIT can be normalized or flowed-through.

reasonable rates. Regulatory principles require CIAC to be accounted for and not be allowed in PUI's rate base. Setting rates as if CIAC funds were an investment made by PUI or the City is unfair to the consumers who made those contributions and to existing consumers who would be asked to cover those costs once again.

PUI claims that the $18 million acquisition price was based on an arms-length negotiation.[7] In general, when one party purchases the assets of another, the buyer wants the price to be as low as possible and the seller wants the price to be as high as possible. This type of negotiation most often leads to a competitive price. In contrast, when an investor owned utility ("IOU") purchases a municipality, there is an incentive for collusion because both sides stand to benefit from a higher purchase price – all at the expense of the consumer. The higher the price, the bigger the check received by the municipality. The higher the price, the greater the IOU's rate base.

Considering that PUI and the City both stand to benefit from a higher acquisition price at the expense of consumers, it is concerning that PUI's valuation study was completed after the acquisition price was determined. These are the specifics regarding the timing of the transaction:

1. **June 6, 2012 - Asset Purchase Agreement (APA) signed for $18 million.**
2. July 6, 2012 - PRC filed application.
3. December 21, 2012 - PSC approved the acquisition.
4. **February 28, 2013 – Tangibl determined Original Cost Less Depression = $18,016,906**.

[7] Mr. Walsh's Direct Testimony, page 5, lines 9-13.

The after the fact valuation study happened to be the same as the acquisition price agreed to before the study ($18 million). Company witness Mr. Daday states, "though similar in amount, the purchase price played no role in the calculation."[8] I agree with Mr. Daday that the fact that these numbers are almost identical is worth noting.

Q. HOW MUCH OF THE $18 MILLION ACQUISITION PRICE SHOULD GO INTO RATE BASE?

A. GDS Associates, Inc. identified $1.29 million of plant book values known to be non-contributed in the City's accounting records.[9] PUI has the burden of proof and the fact that the City kept poor accounting records does not justify PUI, or the City, taking ownership of the CIAC. In my opinion it is not just and reasonable for consumers to forfeit their CIAC unless legislation allows such a practice and if the Commission determines it is in the public interest. For example, a number of states around the country have determined that it is in the public interest to allow IOUs to put the acquisition price into rate base instead of the original cost less deprecation. To my knowledge there is no legislation in South Carolina that allows IOUs to deviate from original cost ratemaking when they purchase a municipal system.

As explained below, the Commission has the authority to make regulatory decisions based on their determination of just and reasonable rates. The Uniform System of Accounts ("USOA") are guidelines to improve the effectiveness of regulation; they should be followed only if the Commission determines these guidelines result in just and reasonable rates. Regardless of what the Commission decides in this proceeding concerning the

[8] Mr. Daday's Direct Testimony, page 7, lines 4-6.
[9] GDS Associates, Inc., The Analysis and Determination of the Value of Donated Assets for Palmetto Utilities Inc.'s Palmetto of Richland County, LLC Service Area, page 8. Exhibit ALR-7.

regulatory treatment of the $18 million acquisition of the City's sewer collection system, the Commission can use this opportunity to establish expectations for future acquisitions of municipal water and wastewater systems. In my opinion, these expectations should include that consumers will be treated fairly, and their CIAC will not be taken from them.

Q. PLEASE EXPLAIN THE PERCENTAGE OF THE $18 MILLION ACQUISITION PRICE PUI IS REQUESTING BE PUT INTO RATE BASE AND THEIR JUSTIFICATION.

A. PUI's primary position is that the entire $18 million acquisition price should be allowed in rate base. Their justification for this position includes the following: (1) The amount paid by the first utility to own an asset ($18 million) is the original cost, (2) the amount of CIAC is unknowable because the City kept poor accounting records,[10] and (3) most of CIAC was used to build assets (e.g., City's Metro WWTP) not purchased by PRC.[11]

Alternatively, Mr. Daday states that "if the Commission were to determine that the USOA did not apply to the City,"[12] $17.1 million of the $18 million acquisition price should be allowed in rate base.

<u>The amount paid by the first utility to own an asset ($18 million) is the original cost</u>

Mr. Walsh's justification for recommending inclusion of the entire $18 million is based on his reading of USOA Instruction 18. He quotes this instruction as saying "… all amounts included in the accounts for utility plant acquired as an operating unit or system, shall be stated at the cost incurred by the person who first devoted the property to utility

[10] See APB Exhibit 2: "City accounting records were ill-kept and grossly incomplete"
[11] Mr. Daday's Direct Testimony, Page 7, lines 11-12.
[12] Ibid. Page 6, lines 10-15.

service."[13] He then claims that the City is not a utility, so in his opinion the acquisition should be recorded as the cost paid by PUI.[14]

Most of CIAC was used to build assets (e.g., City's Metro WWTP) not purchased by PRC

PUI argues that reducing allowable rate base for CIAC applied to plant expansion is not warranted for the following reasons:

1. The amount of plant expansion fees is unknowable.
2. Expansion fees were used to recover cost of capacity for an asset PRC did not purchase - the City's Metro wastewater treatment plant.
3. The City's expansion fee was not cost based – The city used these funds as a slush fund.
4. Under PSC of South Carolina regulation, the 'plant' component of a tap fee involves recovery of only a portion of the cost of a utility's WWTP.

Mr. Daday does not reduce rate base to account for CIAC allocated to the City's wastewater treatment plant. He states that cash CIAC (City "Expansion Fee") "paid by customers was specifically for 'plant expansion'" and PRC did not purchase these assets.[15] Mr. Daday refers to Mr. Walker's testimony for greater clarification regarding why this CIAC should not be excluded from rate base. Mr. Walker argues that the regulatory principle of "used and useful" requires that CIAC allocated to treatment facilities not be excluded from rate base because PRC did not purchase the City's Metro WWTP treatment plant.[16]

[13] Mr. Walsh's Direct Testimony, page 3, lines 10-13.
[14] Ibid. page 4, line 7.
[15] Mr. Daday's Direct Testimony, Page 7, lines 12-14.
[16] Gannett Fleming, Opinion on the Probable Value of Customer Contribution in Aid of Construction Related to the Acquisition of Some Wastewater Assets Owned and Operated by the City of Columbia, South Carolina, August 2018, page 8.

Q. PLEASE EXPLAIN WHY THE FUNDS DONATED BY DEVELOPERS AND CUSTOMERS SHOULD NOT BE PLACED INTO RATE BASE.

A. The appropriate amount that should be included in PUI's rate base is no more than the amount that would be appropriate to add to rate base if the acquired entity was a regulated utility. Any other treatment would be extremely unfair to ratepayers. Original cost ratemaking is based on the principle that items added to rate base that are used and useful and have been prudently incurred at a reasonable cost should be added to rate base in an amount equal to the depreciated original cost, with appropriate adjustments for assets acquired by Contributions in Aid of Construction and deferred income taxes. Consistently applying this procedure is extremely important for at least two reasons.

1) DEPRECIATED ORIGINAL COST DECLINES. When items are first placed into service, rates are high because there is not any accumulated provision for depreciation as of yet. As assets get older, the accumulated provision for depreciation gets larger and larger, making the rate base associated with that asset get smaller and smaller. This procedure causes the charge associated with rate base that is collected from ratepayers to be high in the early years of the life of an asset, but low in the later years. It would be unfair to ratepayers to deny them the benefit of the lower depreciated cost rate base of an asset later in its life after they have been paying for years based on the less depreciated cost earlier in its life. If commissions failed to protect ratepayers from being able to keep this benefit they earned by paying higher rates in the early years of the life of an asset, it would be unfairly taken away.

2) MARKET TO BOOK RATIO PROFIT AMPLIFICATION. In financial markets, the common stock of most public utilities trades at a price meaningfully in excess of book

value most of the time. This means that a company who wishes to acquire a utility company would often be required to pay some amount in excess of its original cost book value. If the acquisition cost became a substitute for the true depreciated original cost of the assets eligible for inclusion in rate base, the mere fact that the acquisition took place would result in an increased charge to ratepayers. This incremental cost is unjustified because it violates original cost ratemaking procedures in a way that is inherently unfair to ratepayers. If such an unfair approach were approved, it would make a fiasco out of rate regulation. One utility could pay a premium for acquiring another, making its rate base higher and allowing it to charge higher rates. Then another company could come along and pay yet another acquisition premium, etc. Each iteration would make rates higher and higher.

Q. PLEASE EXPLAIN WHY YOU RECOMMEND THAT IF THE COMMISSION DECIDES IT IS IN THE PUBLIC INTEREST TO ALLOW A PORTION OF THE DONATED PLANT, IT SHOULD CLEARLY EXPLAIN HOW FUTURE CASES WILL BE TREATED TO MINIMIZE REGULATORY UNCERTAINTY.

A. In this case, both the City of Columbia and PUI are in a position to benefit from a higher sales price at the expense of consumers. There is potential for abuse when a regulated utility purchases an asset from a municipality in general. The Commission should ensure that consumers' interests are protected when an IOU proposes purchasing a municipality system.

Q. PLEASE EXPLAIN WHY THE APPROPRIATE PORTION OF THE $18 MILLION ACQUISITION PRICE THAT WILL GO INTO RATE BASE SHOULD (1) BE JUST AND REASONABLE AND (2) ESTABLISH EXPECTATIONS

REGARDING THE REGULATORY TREATMENT OF MUNICIPAL ASSETS IN FUTURE ACQUISITIONS.

A. The USOA provides detailed accounting instructions to assist effective utility regulation. Commissions have the authority to set rates based on their own accounting system if they determine it is necessary to deviate from USOA to set just and reasonable rates. This flexibility is consistent with Supreme Court opinions. In FPC v. Hope Natural Gas the court states "Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling…".[17] The USOA is a starting point, a default system available, so commissions around the country do not have to waste time re-inventing the rate setting accounting wheel.

Gary Walsh does not recognize the authority granted to this Commission to set just and reasonable rates. He states that the Commission must put the entire $18 million acquisition price into rate base because of accounting rules, leaving no room for flexibility. He claims that USOA rules make the original cost of the sewer collection system irrelevant because the utility assets PRC purchased from the City in 2013 did not meet the USOA definition of a utility.[18] According to Mr. Walsh, USOA Instruction 18 requires that the accounts for utility plant "shall be stated at the cost incurred by the person who first devoted the property to utility service."[19]

See Appendix A for a more in-depth discussion of the purpose of accounting systems, USOA and rate making.

[17] FPC v. Hope Natural Gas, 320U.S. at 602, 605
[18] Mr. Walsh's Direct Testimony, page 4, lines 20-22.
[19] Mr. Walsh's Direct Testimony, Page 3, lines 12-13.

V. PUI'S REQUEST TO LIMITED SERVICE INTERRUPTION LIABILITY

Q. PLEASE RESPOND TO PUI'S REQUEST TO LIMIT THEIR LIABILITY REGARDING SERVICE INTERRUPTIONS.

A. It is my understanding that under South Carolina regulation PUI's only obligation is to resume service as quickly as possible. Limiting the Company's liability is not a benefit to customers.

VI. CONCLUSION

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN THIS CASE.

A. **A.** I recommend the following:

1. **TCJA:** Commission order PUI to refund ratepayers the accumulated excess deferred income taxes they collected as a result of the passage of the TCJA.

3. **City Sewer Collection System Acquisition:** $1.29 million of the $18 million acquisition price be allowed to go into rate base.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

APPENDIX A: UNIFORM SYSTEM OF ACCOUNTS

Accounting is a system of rules, procedures and principles that help measure the economics (e.g. profits, losses) of companies, including regulated utilities. Accounting data is used by management, investors, government and regulators to make decisions. For most companies accounting data is a report card, an output. For regulated utilities, however, accounting can influence the economics.

Filing Requirements - IOUs

Utilities have multiple filing requirements, including those required by the Securities and Exchange Commission (SEC) and regulators (states and federal). The SEC requires utilities to file accounting information in accordance with Generally Accepted Accounting Principles (GAAP). The Federal Energy Regulatory Commission (FERC) require utilities, under their jurisdiction, to file accounting information based on FERC Uniform System of Accounts (USOA).

Both USOA and GAAP (for utilities through Accounting Standards Codification ASC 980 – Regulated Operations) were developed with the prevailing cost-of-service model in mind for utilities. State regulators have the authority to set rates based on different accounting rules than GAAP if they determine that doing so is in the public interest. In practice, GAAP and USOA accounting requirements are usually the same.

GAAP

GAAP is governed by the Financial Accounting Standards Board (FASB). The purpose of GAAP, established by the Financial Accounting Standards Board (FASB), is to provide investors with uniform financial information so they can make informed decisions. It is up to

utility commissions, not FASB, to decide how to determine just and reasonable utility rates. For example, ASC 980 requires that when certain regulatory actions (e.g., cost disallowance) are probable and estimable, the estimated amount must be recognized as a loss. This requirement helps investors understand the financial condition of a utility company so they can decide how much the shares of the company are worth and if they would like to buy them or not. If a utility does not comply with GAAP, they are subject to fines and possibly criminal charges. Companies are allowed to provide investors "non-GAAP" financials in their investor presentations, but they are required to show investors how they made the calculations and how the results compare to results that are consistent with GAAP.

USOA

The USOA impacts the rates that utilities will charge their consumers, revenues, expenses, earnings and ultimately their share price. The purpose of USOA, created by the Federal Energy Regulatory Commission (FERC) in 1937, is to increase regulators' capacity to provide effective regulation. The USOA "…provides detailed descriptions of the activities for which the financial impacts are to be included in each account." For example, the USOA provides instructions for the types of expenditures included in the costs of an electric plant. These instructions provide the consistency needed for regulators to monitor utility performance, but the USOA's impacts are more consequential than record-keeping. The USOA impacts rates.

Utility Commission Authority

Utility commissions do not have the authority to change GAAP. They do have the authority to change the USOA, however, if they determine it is in the public interest. Most state regulators require utilities to file in a format consistent with FERC USOA. State

regulators can require their utilities to file based on their own system of accounts and change what costs go into rates.